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TESTIMONY OF
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ON BEHALF OF
CREDIT UNION NATIONAL ASSOCIATION
BEFORE THE
HOUSE FINANCIAL SERVICES
SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
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“The Role of Check Truncation at Credit Unions”

Good Morning, Chairman Bachus, Ranking Member Sanders, and members of the Subcommittee. Thank you for the opportunity to provide comments on H.R. 1474, the Check Clearing for the 21st Century Act, and on how check truncation has been working at credit unions for three decades. I am Celia Woodham, Director of Operations at Chartway Federal Credit Union in Virginia Beach, Virginia. I am testifying before you today on behalf of the Credit Union National Association (CUNA), which represents more than 90 percent of the nation’s 10,000 state and federal credit unions. As you know, credit unions are cooperative non-profit financial institutions organized to provide individuals associated by a common bond with a place to save and a source of loans at reasonable rates.

I would like to share with you information regarding the following:

- The experience of credit unions with check imaging systems and check truncation techniques and what the credit union movement and my institution have done to protect themselves and their members from fraud and double debiting;
- The effect this legislation will have on the payments system and what benefits consumer may realize as a result;
- How this legislation will affect credit unions and impact the ability of credit unions to provide services to our members; and
- The ability of the consumer protections within the bill to protect consumers.

Credit Unions’ Truncation and Imaging Systems & Fraud Protections

Credit unions have had extensive experience with check truncation for nearly three decades. When the National Credit Union Administration (NCUA) authorized all credit unions to provide share draft accounts in 1977, NCUA initially required truncation.¹ This followed a pilot program of check truncation underway since 1974. As a result, most credit unions that offer checking accounts truncate. Sixty-four percent of credit unions offer checking accounts, and of those credit unions ninety-one percent truncate share drafts or checks.² Among the credit unions that offer checking accounts, 7.1% include images of all checks within the statements that their members receive. Although only two thirds of credit unions truncate, nearly all credit union members have access to checking accounts. In fact, 96.1% of credit unions’ members are in credit unions that offer checks.

Initially, the NCUA required all credit unions offering share draft accounts to truncate and NCUA defined truncation as when the original share draft was not returned to the credit union member. As a result, in the past and now, credit unions tend to truncate checks at the last step in the check collection process by not distributing share drafts to their credit union members. Under this system, there are two processes. In the first case, a credit union may receive the checks that a member writes against his or her account at

¹ Share draft accounts at credit unions are equivalent to checking accounts at banks.

² Share drafts are checks

the credit union, but the credit union does not pass those checks onto the member. In the second case, a credit union may have their members' checks truncated by a Federal Reserve Bank or a third-party processor, and the essential share draft information is transmitted electronically to the credit union for payment or dishonor. In this scenario, neither the credit union nor the member receives the original paper check. For all credit unions, each share draft or check is itemized on the statement that the member receives.

In turn, I would like to describe the experience of my credit union, which is a \$852 million asset institution with 135,194 members and 68,310 share draft accounts. We do not image our share drafts since the Federal Reserve Bank in Richmond processes and truncates for us. We receive CDs with the check images for the checks processed each day. This allows us to produce good quality copies if the members request them for subpoena purposes. Last year we processed about 1.7 million checks drawn on other financial institutions worth over \$1 billion. We have never had a member complain about receiving an image of the check rather than an original.

Credit unions, like other financial institutions, have seen check fraud escalate dramatically in recent years. It has been reported that check fraud for credit unions has increased at an astonishing rate of 200 percent over the past few years.

This broad increase in check fraud is not related to truncation, however, but is more likely related to the ease with which people steal and counterfeit paper checks. For example, there are reports of check fraud from thieves stealing mail or scouring garbage cans for canceled checks. At Chartway Federal Credit Union, most of the check fraud stems from stolen checks. The processing of checks provides these opportunities. Whereas the electronic system of check truncation cuts down on the transportation and availability of paper checks, which would probably leave fewer opportunities for those criminals to engage in check fraud.

In order to combat against check fraud generally, credit unions have engaged in several tactics to cut down on the number of bad checks. Many credit unions have increased teller awareness to detect common signs of check fraud, including, but not limited to: (1) checks that do not have MICR lines; (2) a routing code in the MICR line that does not match the individual's financial institution's address; (3) MICR ink that is shiny or raised; (4) check colors that smear when rubbed; (5) and a personal check that has no perforated edge. In addition, some credit unions have instituted newer technologies that can immediately detect a fraudulent check. Certain fraud prevention products can access a dial-up MICR reader to receive check verification within 10 seconds. At Chartway Federal Credit Union, in order to protect our members against check fraud we have the teller examine checks and we engage in member education regarding identity theft prevention.

There is a concern that double debits could be a result of this legislation if a paying financial institution receives a substitute check and an electronic file for the same item and posts both. The experience of credit unions generally and at Chartway Federal Credit

Union specifically, is that the check truncation programs used by credit unions do not present a greater opportunity for double debiting of checking accounts. For instance, Chartway has never received the electronic check and the paper check because a Federal Reserve Bank does our processing. Likewise, credit unions that process with corporate credit unions have not had a problem with double debits. In instances when Chartway Federal Credit Union has seen a duplicative posting it has been able to reverse it expeditiously, sometimes even before the member is aware that it has occurred. Otherwise, it is resolved as quickly as possible within the normal complaint processing. We are confident that increased truncation will not raise the frequency of double debits.

The Effect This Legislation Will Have on the Payments System and the Benefits Consumers May Realize As a Result

The Check Clearing for the 21st Century Act (H.R. 1474) that was introduced by Representatives Hart and Ford would encourage truncation by removing legal barriers that currently discourage truncation. Currently, financial institutions cannot send electronic checks to another financial institution without prior agreements beforehand to do so. With this legislation, financial institutions would be able to send electronic checks without prior agreements. Those institutions that did not want to receive an electronic check could still request a substitute check (a paper copy of the original) under the legislation. Therefore, it allows electronic check processing to be used by a number of institutions without requiring them to engage in the costly process of negotiating several individual agreements.

As a result, this legislation would increase check truncation among financial institutions and provide numerous advantages to the payments system. Electronic check processing would likely quicken the collection and return of checks, reduce the costs of processing checks, eliminate the need to physically transport checks, and reduce the vulnerability of our check system to attacks that affect our transportation networks.

At credit unions, truncation has provided numerous advantages to our members. For instance, some credit unions have combined check truncation programs with check imaging systems. Imaging checks has allowed some credit unions to post images online and increase the access their members have to their used checks. As a result, imaging and truncation have substantially reduced the time for some credit unions to retrieve a check for their member and make retrieval virtually instantaneous. Moreover, usage of imaging allows credit union personnel to investigate complaints and resolve disputes more quickly.

This Legislation Would Encourage Increased Truncation at Credit Unions and Enhance the Ability of Credit Unions to Provide Services to Our Members

In particular, this legislation would encourage increased truncation at credit unions because credit unions do not usually truncate all the checks that they process. For example, credit unions do not truncate the checks drawn on other financial institutions that their members deposit or use to make loan payments at the credit union. Credit unions process these checks manually as paper items. With this legislation, credit unions

would be encouraged to truncate these deposited checks as well. In other words, credit unions could keep those deposited checks and send an electronic check to the collecting or paying financial institution.

The ability of credit unions to truncate checks drawn on other institutions may help them enhance current services to their members. For example, electronic checks are usually returned faster than paper checks. Thus a credit union may be able to inform a member faster if an electronic check that the member deposited is not good.

The Ability of the Consumer Protections Within the Bill to Protect Consumers

As a result of this bill, consumers would probably not receive their checks. However, the experience of credit unions with check truncation does not indicate that this should disadvantage consumers. The experience of credit unions is that our members rarely request or need originals from truncated share drafts or checks. In fact, some credit unions never provide originals because they destroy the originals within 2-3 business days. An informal survey of corporate credit unions, credit unions that provide services for other credit unions, confirmed this. In 2001, corporate credit unions processed over 1.1 billion items in total check volume. Of those 1.1 billion checks, only about 480,000 requests were made for the original check, representing .04 percent of all checks. In almost all cases, the corporate credit union could make a good-quality, clear image of the check that satisfied the member's needs.

In addition, this bill impacts consumers because it encourages the electronic processing of checks, instead of paper processing of checks. For all the reasons mentioned above, this should improve efficiency within the payments system without compromising privacy. The accessibility of paper checks to transporters of checks and personnel make them much more of a privacy risk than electronic files, which often have greater security features such as password and encryption enhancements. Therefore, the increase in electronic processing should not negatively impact consumers.

Moreover, H.R. 1474 would provide sufficient consumer protections to ensure that consumers are not disadvantaged by this legislation. The bill provides specific expedited recredit rights for those consumers that assert that the bank charges the consumer's account improperly or that the substitute check was inaccurate, illegible, or violated a warranty. Consumers must show that they suffered a loss and that the production of the original or a better copy of the original is necessary to determine the validity of any claim. If a member suffered a loss because of the substitute check, the member's credit union under certain circumstances would be required to recredit the account of the member up to \$2,500 by the end of the tenth business day following receipt of the member's notice that a substitute check was not properly charged to the account. This approach appears reasonable. The recredit procedure gives the member's credit union 10 business days to investigate the claim before being required to recredit the member and 45 calendar days for certain unique circumstances. These provisions provide sufficient protections for consumers and the credit union. For instance, the credit union's ability to investigate a consumer's claim prior to being required to recredit the consumer's account

is essential for the credit union to avoid fraud losses from the new expedited recredit procedure. Similarly, the expedited recredit procedure in the bill does not require the credit union to provide notice to the member before reversing a claim that is not substantiated. This allows a credit union to stop a fraud that is in progress.

Moreover, the consumer provisions found in H.R. 1474 appear to reflect the experience that credit unions have had with check truncation. The legislation allows an indemnifying financial institution to produce a copy to resolve a consumer's claim when it is sufficient for that purpose. The experience of credit unions is that at nearly all times a good quality copy is adequate to resolve disputes. The change is especially important because frequently the original will be destroyed within a few days and might not be available anyway.

We also support Section 7 in H.R. 1474 that provides ground rules regarding when a financial institution that has suffered a loss from a substitute check must be recredited by an indemnifying bank. Under Section 7, a claimant financial institution has 120 days to make a claim that it suffered a loss as a result of a substitute check. After that, the indemnifying bank must respond within 10 business days by giving the appropriate recredit, or a copy of the check showing that the claim is unfounded, or information why the bank does not need to provide either of those two responses. Placing a time limit on responses to claims among financial institutions protects smaller institutions and ensures that paying financial institutions do not disproportionately bear the burden for substitute checks that may have been mishandled earlier in the collection process by an indemnifying bank.

Conclusion

In conclusion, most credit unions throughout the country in addition to Chartway Federal Credit Union truncate their share drafts or checks, and have done so for decades. This legislation will increase electronic check processing that produces benefits for financial institutions and consumers. We look forward to working with the Subcommittee, the Federal Reserve and consumers in further strengthening this proposal.

Thank you for this opportunity to comment and I will be glad to answer any questions.